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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1995

CITIZENS BANK OF MARYLAND,
Petitioner,
v.
DAVID STRUMPF,
Respondent.

BRIEF OF BANKAMERICA CORPORATION AS AMICUS CURIAE IN SUPPORT OF PETITIONER

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INTEREST OF THE AMICUS CURIAE

BankAmerica Corporation ("Amicus") is a bank holding company which, through its subsidiaries, transacts banking business on a national basis. Amicus currently operates banks which provide deposit account services on over fifteen million accounts with over $120 billion on deposit in 13 states. The Fourth Circuit's ruling in this case directly affects Amicus's dealings (through its subsidiaries) with significant numbers of depositors who commence bankruptcy proceedings each year. These deposit accounts are accorded the protection of and are deemed security for repayment of obligations owing to the banks pursuant to §506(a) of the Bankruptcy Code[1]. Amicus therefore has a

[1]The United States Bankruptcy Code, 11 U.S.C. §§ 101 *et seq.*, referred to hereafter as the Bankruptcy Code.

great stake in the proper interpretation of the Bankruptcy Code provisions at issue here to insure that its property rights in the deposit accounts are preserved.

The judgment of the United States Court of Appeals for the Fourth Circuit is manifestly incorrect. If the Fourth Circuit's judgment is allowed to remain the law, Amicus and other depositories will be required to forego statutorily granted property rights without a hearing or other due process of law in order to avoid liability for contempt. This result conflicts with constitutional principles and the Bankruptcy Code itself.

Because of this case's substantial impact on the banking community, Amicus believes that its views on the proper interpretation of the law may be of assistance to the Court's consideration of this case.

QUESTION PRESENTED FOR REVIEW

Whether a bank creditor may refuse a bankrupt depositor's request to withdraw funds pending determination by the bankruptcy court of the bank's setoff rights, without violating the bankruptcy stay under 11 U.S.C. § 362(a).

INTRODUCTION AND SUMMARY OF ARGUMENT

The United States Court of Appeals for the Fourth Circuit has effectively stood the Bankruptcy Code on its head by misinterpreting a procedural device so as to invalidate a substantive property right. The Fourth Circuit mistakenly found a depository bank's administrative hold on a bankruptcy debtor's demand deposit account "tantamount to the exercise of a right of setoff" and in violation of the automatic stay of §362(a)(7). *In re Strumpf*, 37 F. 3d 155, 158 (4th Cir. 1994). Thus, the debtor had the right to immediate withdrawal of the funds on deposit. The depository bank's right of setoff, which is a protected security interest under the Bankruptcy Code, was destroyed.

If the decision below is allowed to stand, a depository bank holding cash subject to a right of setoff has absolutely no way to protect itself from a debtor who withdraws cash post-petition, since the bank cannot put an administrative hold on the account. By the time the bank obtains hollow judicial relief, the cash will have been dissipated beyond recovery. The effect of the Fourth Circuit's error is to deny banks and other depository institutions a substantive property right without notice or opportunity to be heard, thereby denying due process of law as guaranteed under the Fifth Amendment to the United States Constitution.

It is essential to keep two incontrovertible concepts firmly at hand. First, a demand deposit account is merely a payable on the books of the depository, not a discrete fund of a depositor's money held in trust. *Keller v. Fredericktown Sav. Inst.*, 66 A. 2d 924, 925 (Md. 1949); *Gordon, Feinblatt, Rothman, Hoffberger & Hollander v. Gerhold*, 608 A. 2d 1194, 1201 (Md. App. 1992). Second, the Bankruptcy Code makes no distinction between the setoff rights of a depository and those of any other creditor. Rather, it is the courts which have created unwarranted distinctions between classes of creditors holding setoff rights.

The issue of setoff is perhaps most focused with depositories due to the ease with which demand deposit accounts are accessed. Unique among creditors who may assert setoff rights, the depository is faced with an immediate demand for turnover of funds through the presentation of a draft or check for payment. The depository must then either honor the check, thereby losing the right to setoff mutual obligations, or dishonor the check and preserve such rights. If the second course is chosen, the depository "freezes" or holds the account. This administrative hold properly should not be

viewed as an act but as a refusal to act in the face of an unlawful attempt by the debtor to withdraw funds.

The result below is based on multiple misreadings of the Bankruptcy Code. The briefs of Petitioner, and other parties allied with Petitioner, will address the manifest statutory errors of the Fourth Circuit's interpretation of §§ 362(a)(7), 553, and 542(b) of the Bankruptcy Code. Therefore, this amicus brief will focus solely on the constitutional issue.

Amicus urges the Court to dispose of this case on statutory grounds, thereby avoiding the Fifth Amendment issues. *See, e.g., Edward J. DeBartolo Corp. v. Florida Gulf Coast Building and Construction Trades Council*, 485 U.S. 568, 575, 108 S. Ct. 1392, 99 L. Ed. 2d 645 (1988) ("[W]here an otherwise acceptable construction of a statute would raise serious constitutional problems, the Court will construe the statute to avoid such problems unless such construction is plainly contrary to the intent of Congress"). Here, the Fourth Circuit's construction of the Bankruptcy Code was not "otherwise acceptable"; but even if it were, Amicus respectfully submits that this Court should construe the statutes so as to forestall the constitutional issue. However, if the Court finds constitutional analysis necessary, Amicus respectfully submits that the Fourth Circuit's decision creates a clear violation of the Fifth Amendment.

ARGUMENT

THE FOURTH CIRCUIT'S INTERPRETATION OF § 362(a)(7) OF THE BANKRUPTCY CODE RESULTS IN A TAKING OF PROPERTY WITHOUT CONSTITUTIONALLY PROTECTED DUE PROCESS OF LAW

The Fourth Circuit has interpreted § 362(a)(7) to prohibit an "administrative freeze" intended to preserve the

right of setoff recognized by § 553(a). Amicus respectfully submits that the Fourth Circuit erred in its interpretation, with the result that Petitioner was denied its property without a hearing and without due process of law.

A. SECTION 506(a) OF THE BANKRUPTCY CODE CONFERS SECURED STATUS ON CREDITORS HOLDING A RIGHT OF SETOFF

Section 506(a) of the Bankruptcy Code accords the status of a secured creditor to a party holding rights of setoff, to the extent of the amount subject to setoff. Section 506(a) provides: "An allowed claim of a creditor ... that is subject to setoff under section 533 of this title, is a *secured claim* ... to the extent of the amount subject to setoff...." [Emphasis added.] The legislative history of the Bankruptcy Code demonstrates that Congress carefully delineated the right of setoff as a secured claim:

> Section 506(a) of the House amendment adopts the provision contained in the Senate amendment and rejects a contrary provision as contained in H.R. 8200 as passed by the House. The provision contained in the Senate amendment and adopted by the House amendment recognizes that *an amount subject to set-off is sufficient to recognize a secured status in the holder of such right.* [124 Cong.Rec. S17403, S17411 (October 6, 1978); emphasis added.]

Thus, a depository bank holding a right of setoff is a secured creditor holding a secured claim, as a matter of Federal law.

The legal effect of such status is that the property subject to the setoff cannot be used, sold or leased unless the secured creditor consents or the Court, with or without a hearing, determines that such property interest is adequately

protected.[2] This does not mean, however, that the party holding setoff rights may enforce them. The automatic stay of § 362(a)(7) acts as a counterbalance, and restrains setoff until the Court grants relief from stay to effect the setoff.

The Fourth Circuit balanced § 553 against § 362 and erroneously ruled that the stay against setoff compelled Petitioner to turn over the funds in debtor-Respondent's checking account to Respondent, thereby destroying Petitioner's setoff rights, on pain of contempt. Thus, in effect, the stay provision was used to trump Petitioner's substantive setoff rights, and allowed Respondent access to funds which it was legally unable to use without affording adequate protection.

B. THE DESTRUCTION OF A SECURED CLAIM IS A TAKING UNDER THE FIFTH AMENDMENT TO THE CONSTITUTION

The Fifth Amendment declares that no person shall be "deprived of life, liberty, or property, without due process of law . . . ." The Fourth Circuit's opinion creates a violation of this principle.

This Court addressed the interplay between the Bankruptcy Code and the Fifth Amendment in the case of *U. S. v. Security Industrial Bank*, 45 U. S. 70, 103 S. Ct. 407, 74 L. Ed. 2d 235 (1982), in which the Court held that the Bankruptcy Code cannot be construed so as to destroy the property rights of secured creditors. The holder of a setoff right recognized by § 553 of the Bankruptcy Code is ac-

[2]Section 363(e), as relevant, provides:

> Notwithstanding any other provision of this section, at any time, on request of an entity that has an interest in property used, sold, or leased, or proposed to be used, sold, or leased, by the trustee, the court, with or without a hearing, shall prohibit or condition such use, sale, or lease as is necessary to provide adequate protection of such interest.

corded the legal status of a secured creditor and holds a secured claim to the extent of the amount subject to setoff. *See* § 506(a); *Matter of Lawndale Steel Co.*, 155 Bankr. 990, 992 (Bkrtcy. N.D.Ill. 1993). The question at issue in *Security Industrial* was whether § 522(f) of the Bankruptcy Code could be applied to allow a debtor to avoid a non-purchase money, non-possessory security interest in personal property pre-existing the effective date of the Bankruptcy Code. To avoid a taking under the Fifth Amendment, the Court declined to apply this statute retrospectively. The Court examined the relationship between the bankruptcy statutes and the Fifth Amendment, and noted that if a bankruptcy statute destroys property rights, the statute cannot be defended on "rational basis" grounds:

> It may be readily agreed that § 522(f)(2) is a rational exercise of Congress' authority under Article I, Section 8, Clause 4, and that this authority has been regularly construed to authorize the retrospective impairment of contractual obligations . . . . Such agreement does not, however, obviate the additional difficulty that arises when that power is sought to be used to defeat traditional property interests. *The bankruptcy power is subject to the Fifth Amendment's prohibition against taking private property without compensation* . . . . Thus, however "rational" the exercise of the bankruptcy power may be, that inquiry is quite separate from the question whether the enactment takes property within the prohibition of the Fifth Amendment. 459 U. S. at 74-75 (citations omitted and emphasis added).

The Court carefully distinguished between the rights of secured and unsecured creditors, rejecting the argument of the government that a secured party's rights are deserving of no greater protection under the takings clause than traditional contract rights. *Id.* at 75. The Court stated: "However

'bankruptcy principles' may speak to this question, our cases recognize, as did the common law, that the contractual right of a secured creditor to obtain repayment of his debt may be quite different in legal contemplation from the property right to the same creditor in the collateral." *Id.*

The Court then discussed the cases establishing that the destruction of a lien is a taking. The government argued that the bankruptcy law had simply imposed a general economic regulation which in effect transferred the property interest from a private creditor to a private debtor, and therefore was not a taking because the government had not acquired for itself the property in question. *Id.* at 78, 79. The Court, however, refused to permit the destruction of a secured creditor's lien rights without affording that secured creditor due process of law.

The analysis in *Security Industrial* applies forcefully to the facts of this case. If § 362(a)(7) is so broadly interpreted as to permit a debtor to take and spend funds subject to the right of setoff, then the right of setoff becomes meaningless as a practical matter. If the insolvent debtor is permitted immediate and unfettered access to its funds, the funds will be irretrievably dissipated and the bank's property rights as secured creditor will have been destroyed — unconstitutionally taken — by the Bankruptcy Code. *See In re George Ruggiere Chrysler-Plymouth*, 727 F. 2d 1017, 1019 (11th Cir. 1984) ("the Bankruptcy Court cannot allow the secured interest to be threatened by improper use of cash proceeds").

The destruction of the right of setoff is, in essence, the taking of the depository bank's cash collateral. Congress expressly recognized the Fifth Amendment issues raised by

the use of cash collateral, and consequently enacted the adequate protection standards set forth in § 361:

> The concept [of adequate protection] is derived from the fifth amendment protection of property interests. *See Wright v. Union Central Life Ins. Co.*, 311 U. S. 273 (1940); *Louisville Joint Stock Land Bank v. Radford*, 295 U. S. 555 (1935). It is not intended to be confined strictly to the constitutional protection required, however. The section, and the concept of adequate protection, is based as much on policy grounds as on constitutional grounds. *Secured creditors should not be deprived the benefit of their bargain. . . .*

H.R. Rep. No. 95-595, 95th Cong., 1st Sess., *reprinted in* U.S.C.C.A.N. 5787, 6295 (emphasis supplied). *See also In re Born*, 10 Bankr. 43, 48 (Bkrtcy. S.D. Tex. 1981) ("The very heart of the concept of adequate protection is to assure the secured creditor that as the bankruptcy procedures unfold he will not be faced with a decrease in the value of his collateral"). In order to prevent unconstitutional takings, the Bankruptcy Code requires (among other things) a hearing prior to the use of cash collateral under 11 U.S.C. § 363(c)(2)(B): "The trustee may not use . . . cash collateral . . . unless (2) the court, after notice and a hearing, authorizes such use . . . ." In keeping with Congressional deference to the Fifth Amendment, the setoff provisions in the Bankruptcy Code should also be interpreted so as to preserve the depository bank's cash collateral.

As demonstrated in Petitioner's brief, there is no reason to reach this conflict between Fifth Amendment and bankruptcy law, because when Congress enacted the Bankruptcy Code it specifically protected setoff rights against such an

unconstitutional taking. In its ruling, the Fourth Circuit simply ignored § 542(b), which provides:

> Except as provided in subsection (c) or (d) of this section, an entity that owes a debt that is property of the estate and that is matured, payable on demand, or payable on order, shall pay such debt to, or on the order of, the trustee, *except to the extent that such debt may be offset under Section 553 of this title against a claim against the debtor.* [Emphasis added.]

Section 542(b) is relegated to a mere footnote in the Fourth Circuit's opinion. *Strumpf*, 37 F.3d at 157, fn. *. By failing to consider Section 542(b), the Fourth Circuit construed the Bankruptcy Code so as to create a violation of the Fifth Amendment. The view of the Fourth Circuit should be rejected, and the Bankruptcy Code should be interpreted in a manner consistent with the Fifth Amendment.

CONCLUSION

Banks and other depositories are not the only creditors who hold rights of setoff recognized by the Bankruptcy Code, but they are uniquely affected by the Fourth Circuit's ruling. Other creditors who may have rights of setoff are not required by the Fourth Circuit's opinion to forfeit their rights in order to avoid contempt. *The opinion appears to apply only to deposit accounts.*

In order to protect its setoff rights, the bank or other depository should be able to place an administrative freeze on the funds, which will preserve the *status quo* and prevent an unconstitutional taking of the bank's secured claim. This Court should construe the applicable provisions of the Bankruptcy Code to avoid destroying banks' secured rights in violation of the Fifth Amendment. In this manner the constitutional and economic rights of the parties can be

protected. For the foregoing reasons, Amicus urges that this Court reverse the decision of the Fourth Circuit.

Respectfully Submitted

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